# Tax News
## November 2006

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**Some head of household e-filers receive erroneous NPAs**
Software used by some of our head of household e-filers inserted incorrect information on the head of household audit questionnaire, resulting in our automated system issuing erroneous Notices of Proposed Assessment. Find out what to do if your clients were affected.

**Check casher businesses to receive reminder letter**
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**AB 2341 enacted, eliminating need for tax clearance certificate**
Things just got a little easier for certain business entities that are dissolving or canceling their businesses. The passage of AB 2341 eliminated the tax clearance certificate requirement, and means that many dissolving corporations won't get caught having to pay their annual or minimum tax *after* going out of business.

**California's new filing requirements for registered domestic partners**
Another law passed in the recent session requires registered domestic partners to use the same filing status applicable under federal law to married couples. This law does not, however, affect federal law. FTB seeks public input in understanding all the issues that may affect registered domestic partners filing California tax returns.

**Real estate withholding law changes for 2007**
AB 2962 makes changes to real estate withholding requirements for all transactions closing on or after January 1, 2007. Sellers may now choose the original withholding method (withholding three and one-third of the property's sales price), or elect an alternate withholding amount that is based on applying the maximum tax rate to the seller's estimated gain.

**Make sure you're using FTB-approved substitute or scannable forms**
Forms generated from your tax preparation software must meet the requirements of our Substitute Forms Program. Avoid costly processing snags caused by using unapproved forms – check with your software provider, and check out our list of software companies who have stated their intent to comply with our forms requirements for tax year 2006.

**Disclosure of list of corporations under audit**
In an unintentional email disclosure on September 20, 2006, FTB revealed several corporations under audit. In this article, we describe what we are doing to repair the origin of the problem, in combination with our ongoing efforts to safeguard confidential taxpayer data.

## Taxing municipal bond interest in California

What effect does the recent Kentucky Supreme Court decision on taxation of interest on out-of-state municipal bonds have on California? Find out how FTB is handling this issue for California taxpayers.

## Criminal Corner

Our monthly summary on bringing tax criminals to justice, and closing the tax gap one case at a time.

## The buzz on big business

### California Supreme Court issues decisions on Microsoft and General Motors

The California Supreme Court issued two decisions on August 17, 2006, affecting apportioning corporations. Although the California Supreme Court decisions are not final, we are evaluating the decisions and guidance from the two cases, and exploring how to incorporate the guidance from these decisions in the audits of other taxpayers.

## Erroneous NPAs sent to some head of household e-filers

The Franchise Tax Board (FTB) recently became aware that some tax return preparation software inserted erroneous information on professionally prepared e-filed returns meeting these conditions:

- Head of household filing status.
- Schedule 4803, *Head of Household Questionnaire* attached.

Specifically, the software inserted incorrect answers for two questions on the Schedule 4803E:

- **Question 4** (“Did you provide more than one-half of the support for your qualifying person in 2005?”).
- **Question 10** (“Was your qualifying dependent a citizen of the U.S., or a resident of the U.S., Canada, or Mexico?”).

FTB issued Notices of Proposed Assessments (NPAs) dated September 14, 2006, and September 21, 2006, for HOH questionnaires meeting the above criteria.

Working with software manufacturers and tax preparers, we identified 3,275 taxpayers who received erroneous NPAs. We issued NPA withdrawal notices on October 4, and October 16, 2006.

If any of your clients received a head of household NPA dated September 14 or September 21 that met the conditions described above, and they have **not** received a withdrawal notice, follow the protest procedures shown on the NPA.

### Check casher businesses to receive reminder letter

In November 2006, FTB will mail letters to check casher businesses operating in California. The letter is a reminder of information reporting requirements that went into effect on January 1, 2006. The letter assures check cashers that we understand the new information reporting requires check casher businesses to collect, maintain, and report check casher transaction data, and we will take this into consideration when determining if a check casher made a reasonable effort to comply. We will continue to seek ways to ease the reporting burden.

Check casher businesses should note that we eliminated the paper filing option for this filing period, and will only accept reports submitted on CD-ROM disk. Check cashers who are unable to report the required transaction information due to inadequate computer resources, may be eligible for a waiver from CD-ROM reporting. Request a waiver by submitting Form FTB 3607, C*heck Casher Information Reporting Waiver Request Form.* **Note**: This form will be available November 10, 2006. The waiver request can be submitted anytime before April 2, 2007.

Visit our check casher Webpage located on our Website at www@ftb.ca.gov (keyword "check casher") for the most current news and information on this program, including instructions, record layout, and mailing procedures. If you need assistance, call our Information Reporting Helpdesk at (916) 845-6304 or send us an email at IRPhelp@ftb.ca.gov. We are available Monday through Friday except for official State holidays.

**2006 Chaptered legislation**

The following is a summary of tax-related legislation signed by Governor Schwarzenegger by September 30, 2006.

**AB 339 (Harman, Stats. 2006, Ch. 495).** This act adopts provisions of the Uniform Limited Partnership Act of 2008, allowing a general partner to be shielded from liability for the debts and obligations of the limited partnership.

**AB 546 (Garcia, Stats. 2006, Ch. 848).** It is unlawful to knowingly use a state-owned or state-leased computer to access, view, download, or otherwise obtain obscene matter.

**AB 970 (Torrico, Stats. 2006, Ch. 343).** A corporation is allowed to file a tax return on behalf of certain nonresident directors.

**AB 1282 (Mullin, Stats. 2006, Ch. 712).** The availability of the Employer Child Care Program Credit and the Employer Child Care Contribution Credit is extended to taxable years beginning on or after January 1, 2007, and before January 1, 2012. The bill will revise the automatic repeal date for both credits to December 1, 2012.

**AB 1302 (Horton, Stats. 2006, Ch. 713).** New procedures adopting "emergency regulations" are established for state agencies.

**AB 1418 (Horton, Stats. 2006, Ch. 716).** On their respective Websites, the State Board of Equalization and the Franchise Tax Board are required to make public a list of each agency's top 250 tax delinquencies in the state.

**AB 1550 (Arambula, Stats. 2006, Ch. 718).** This act makes various changes and reforms to the law applying to the following Economic Development Areas:

- Designation of Enterprise Zones.
- Designation of Targeted Employment Areas.
- Designation of G-TEDAs (Geographically targeted economic development areas).
- Tax Incentives.

**AB 1798 (Berg, Stats. 2006, Ch. 896).** The severe rainstorms and related events that occurred in Del Norte, Humboldt, Lake, Mendocino, Napa, Sonoma, and Trinity counties starting in December 2005, are added to the current list of specified disasters under the Personal Income Tax Law and the Corporation Tax Law.

**AB 1806 (Assembly Budget Committee, Stats. 2006, Ch. 69).** The following statutory changes relating to the Budget Act of 2006 are made:

- Repeal the sunset date for Department of Housing & Community Development to assess and collect a fee assessed to Enterprise Zones for each application for a hiring credit voucher certificate.

- Modify an existing reporting requirement regarding state agency's internal accounting systems.

**AB 1809 (Assembly Budget Committee, Stats. 2006, Ch. 49).** The Teacher Retention Tax Credit is suspended for the 2006 taxable year.

**AB 2085 (Parra, Stats. 2006, Ch. 607).** Eligibility requirements for financial aid grants issued by the Military Department are modified.

**AB 2098 (Liu, Stats. 2006, Ch. 818).** The Electronic Funds Transfer Task Force is established to develop a comprehensive approach to implementing an electronic payment system for all state agencies.

**AB 2341 (Villines, Stats. 2006, Ch. 773).** This act eliminates the tax clearance certificate requirement for those business entities required to obtain one. The new process provides that the minimum franchise tax or the annual tax will not be assessed for a taxable year if the following conditions are met:

- The entity files a timely final annual tax or minimum franchise tax return for the preceding taxable year.
- The entity did not conduct business in California after the end of the taxable year for which the final return was filed.
- The entity files documents for dissolution, surrender, or cancellation within 12 months of the due date of the final return.

**AB 2367 (LaSuer, Stats. 2006, Ch. 347).** This act clarifies the criminal penalties for persons who willfully divulge computer software obtained by subpoena and for check cashers that willfully fail to report information to FTB regarding certain check cashing transactions.

**AB 2439 (Klehs, Stats. 2006, Ch. 90).** FTB is required to give taxpayers the option of splitting a tax refund made by direct deposit into more than one account.

**AB 2485 (Jones, Stats. 2006, Ch. 296).** This act establishes the California Sea Otter Fund so taxpayers may designate a contribution on the personal income tax return.

**AB 2591 (Keene, Stats. 2006, Ch. 506).** State agencies are required to submit an annual report to the Department of Finance on the status of liquidated and delinquent accounts.

**AB 2638 (Laird, Stats. 2006, Ch. 892).** This act makes changes to the Local Housing Trust Fund Matching Grant Program, and technical amendments under the Revenue and Taxation Code to resolve non-controversial housing-related items.

**AB 2715 (Runner, Stats. 2006, Ch. 423).** This act provides the authority for filing and recording state tax liens by electronic or magnetic media that is substantially the same as the authority for filing a federal tax lien.

**AB 2735 (Nava, Stats. 2006, Ch. 897).** The severe rainstorms and related events that occurred in the following counties in December 2005, January 2006, March 2006, or April 2006, are added to the current list of specified disasters under the Personal Income Tax Law and the Corporation Tax Law: Alameda, Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, El Dorado, Fresno, Kings, Lake, Lassen, Madera, Marin, Mariposa, Merced, Monterey, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, San Luis Obispo, San Mateo, Santa Cruz, Shasta, Sierra, Siskiyou, Solano, Sonoma, Stanislaus, Sutter, Tulare, Tuolumne, Yolo, and Yuba.

This act also adds the wildfires that occurred in San Bernardino County in July 2006 to the current list of specified disasters.

**AB 2831 (Ridley-Thomas, Stats. 2006, Ch. 580).** The repeal date of the Community Development Financial Institution Credit is extended from December 1, 2007, to December 1, 2012.

**AB 2914 (Leno, Stats. 2006, Ch. 426).** This act extends the repeal date for limited liability partnerships to engage in the practice of architecture.

**AB 2962 (Benoit, Stats. 2006, Ch. 428).** This act helps to reduce the amount of over-withholding resulting from provisions requiring withholding on real property sales by allowing a seller of California real estate to elect to withhold three and one-third percent of the sales price, or an amount not less than the maximum tax rate on the gain multiplied by the gain from the sale.

**SB 286 (Lowenthal, Stats. 2006, Ch. 890).** This act makes technical amendments to resolve non-controversial housing-related items under the low-income housing tax credit.

**SB 663 (Migden, Stats. 2006, Ch. 22).** Some taxpayers assert that by qualifying a controlled foreign corporation as a California taxpayer, reportable Subpart F income is not reportable for California purposes. This act closes the loophole.

**SB 763 (Lowenthal, Stats. 2006, Ch. 634).** This act:

- Extends authority to the Department of Housing and Community Development (DHCD) to assess and collect a fee related to the specified economic development areas (EDAs).
- Directs DHCD to develop and adopt regulations that govern vouchering certificates issued by local governments to the specified EDAs.

**SB 1183 (Ackerman, Stats. 2006, Ch. 57).** Conditions are expanded under which a foreign corporation would be exempted from obtaining a certificate of qualification from the Secretary of State.

**SB 1249 (Alquist, Stats. 2006, Ch. 645).** This act:

- Fixes the minimum contribution requirement for the California Fund for Senior Citizens at $250,000.
- Makes changes to the minimum contribution amounts for 12 funds.

**SB 1374 (Cedillo, Stats. 2006, Ch. 513).** The repeal date for current law that allows FTB to provide taxpayer information to city officials is extended from December 31, 2008, to December 31, 2011.

**SB 1436 (Figueroa, Stats. 2006, Ch. 234).** State agencies are required to designate a liaison for small businesses.

**SB 1452 (Speier, Stats. 2006, Ch. 452).** The Omnibus Audit Accountability Act of 2006 is enacted, and requires an ongoing internal audit function of state agencies to safeguard public funds and the public trust.

**SB 1827 (Migden, Stats. 2006, Ch. 802).** Registered domestic partners are required to file personal income tax returns using the same rules applicable to married individuals.

**SB 1852 (Senate Judiciary Committee, Stats. 2006, Ch. 538).** This act makes technical, non-substantive changes to various code sections, including the Revenue and Taxation Code.

## Assembly 2341 enacted, eliminating need for tax clearance certificate

On September 29, 2006, the governor signed Assembly Bill 2341, eliminating the need for a tax clearance certificate. This legislation streamlined the process for dissolving, or canceling the existence of business entities. Before this law was enacted, certain business entities, i.e., foreign corporations had to meet requirements of FTB, before the Secretary of State (SOS) would grant the business's request to terminate. Passage of AB 2341 remedies this situation.

Here are facts about AB 2341, and some scenarios to clarify the effects of this new law on various business entities.

**Entities affected by this law:**

- Corporations.
- Limited liability companies (LLC).
- Limited liability partnerships (LLP).
- Limited partnerships.
- Not-for-profit corporations and exempt entities.

**Effective/operative date:**

- Effective September 29, 2006.
- Operative for taxable years beginning on or after January 1, 2006.

**Specific provisions of this law:**

- Eliminates the tax clearance certificate beginning September 29, 2006.
- Allows entities to avoid the minimum franchise tax or annual tax for the current taxable year, if:
  - The entity files a timely final franchise or annual tax return for the preceding taxable year, including extension.
  - The entity does not conduct any business after the end of the preceding taxable year.
  - Within 12 months of the filing date of the timely final franchise or annual tax return, the entity files appropriate paperwork with the SOS.
- For corporations, considers the filing of a "final" franchise tax return a request for information to dissolve or withdraw.
- Does not allow SOS to file a business entity's documents if the entity is suspended or forfeited with FTB. Suspended or forfeited entities must pay all outstanding balances due, file any delinquent returns, and then request that the entity be revived to good standing. Suspended or forfeited entities should contact FTB at (800) 852-5711 for revivor requirements.

**How does a business entity terminate its existence in California under AB 2341?**

1. File the appropriate termination documents with the SOS. You can find in-depth information, forms, instructions, and examples of the necessary forms on their Website www.ss.ca.gov, or call (916) 653-3795.

2. File a “final franchise tax” or “final annual tax” return with FTB.

3. If a business entity is suspended or forfeited, it would have to be revived to good standing before the SOS would accept its termination documents. To be revived, a business entity must pay all outstanding tax liabilities and file the appropriate returns, including the final franchise tax return.

**AB 2341 scenarios**

**1. A corporation files its returns on a fiscal year basis.**

**Facts:**

- The corporation is a fiscal year (FY) filer with a taxable year ending June 30, 2006.
- Return due date is September 15, 2006.
- Return due date with extension is April 15, 2007.
- FY 2005 “final” return filed on September 15, 2006.
- No business is conducted after June 30, 2006.

**Conclusion:**

The corporation would not be subject to the minimum franchise tax after June 30, 2006, if:

- It files the appropriate dissolution documents with the SOS.
- The SOS accepts the documents by September 15, 2007.
- It does no business after June 30, 2006.
- The corporation is not FTB-suspended or forfeited.

**If the certificate of dissolution is filed later than 12 months**

If the corporation fails to file the documents by September 15, 2007, or the SOS does not accept the dissolution documents, FTB would assess the corporation $800 for each year that it remains active. In this example, FTB would assess the minimum franchise tax for the 2006 and 2007 taxable years.

This example is relevant for an LLC as well, except that it would apply to the annual tax, and the document filed with the SOS would be a *Certificate of Cancellation*.

**2. The LLC files its returns on a calendar year basis.**

**Facts:**

- The LLC is a calendar year filer with a taxable year ending December 31, 2005.
- Return due date is April 15, 2006.
- Return due date with extension is October 15, 2006.
- The LLC filed its 2005 "final" return on November 1, 2006.
- No business was conducted after December 31, 2005.
- The LLC paid the $800 annual tax for the 2006 taxable year.
- Cancellation paperwork was filed and accepted. SOS cancellation date is January 18, 2006.

**Conclusion:**

The LLC would owe the $800 annual tax for the 2006 taxable year since the 2005 return was not timely filed, and the 2006 taxable year was more than 15 days.

**3. A suspended corporation files on a calendar year basis.**

**Facts:**

The corporation:

- Was suspended by FTB on June 15, 1999.
- Filed its 2005 final franchise tax return on May 31, 2006.
- Filed its *Certificate of Dissolution* on October 10, 2006.

**Note:** Qualified foreign stock corporations must file a *Certificate of Surrender* with the SOS.

**Conclusion:**

- The SOS cannot accept the filing of the *Certificate of Dissolution* until the corporation is revived to good standing.
- The corporation must contact FTB to revive. A revivor requires the corporation to file all necessary tax returns and pay any outstanding tax liabilities.
- Once revived, the corporation can re-file the *Certificate of Dissolution* with the SOS within 12 months of the filing date of the timely, final franchise tax return to avoid incurring the minimum franchise tax for future years.

**Note:** Reviving to dissolve or surrender a corporation does not qualify for a walk-through revivor process. It takes at least two weeks to process the corporation revivor request **after** FTB receives returns and payments.

If the corporation fails to file its *Certificate of Dissolution* by May 31, 2007, or the SOS does not accept the dissolution documents by that date, the corporation would be liable for the 2006 minimum franchise tax, and remain liable for each subsequent year that it remains active.

If you have questions about a previous tax clearance request please contact us at **tax clearance information: (916) 845-4124.**

We are updating Publications 1038, 1038L, and 1038A - *Instructions for Corporations Requesting a Tax Clearance Certificate* to reflect the changes enacted by AB 2341. The current tax clearance-related information in these publications no longer applies, but the publications remain available for the SOS-related information.

If you would like to read more about AB 2341, please visit these Webpages:

- http://www.ftb.ca.gov/law/legis/index.html.
- http://www.leginfo.ca.gov/bilinfo.html.

To see the provisions that applied to taxable years that began before January 1, 2006, refer to Archive - tax clearance prior to 1/01/2006.

### California's new filing requirements for registered domestic partners

SB 1827 was signed into law on September 29, 2006, requiring registered domestic partners to file California tax returns jointly or separately, using the same standards applicable under federal law to married couples. These new filing requirements apply to taxable years beginning on or after January 1, 2007. Under current state and federal law, registered domestic partners use the single, or head of household filing status. The new law has no impact on the federal law.

FTB has convened an implementation team to review the various processes, forms, and systems changes needed before January 1, 2008. We are also establishing a focus group of interested parties, consisting of tax practitioners, the State Bar Association, and domestic partner groups. Taxpayers and interested parties can submit questions on this matter via FTB's Website, www.ftb.ca.gov, or by emailing RDS@ftb.ca.gov.

## Real estate withholding law changes for 2007

On September 22, 2006, the governor signed AB 2962. This new law amends Revenue and Taxation Code Sections 18662 and 18668, making changes to real estate withholding requirements for all transactions closing on or after January 1, 2007.

Previously, where withholding was required, sellers had to withhold three and one-third percent of the property's sale price. Now, sellers may choose between the original withholding method, or elect an alternate withholding amount based on applying the maximum tax rate to the seller's estimated gain. The maximum tax rates are:

- Individuals: 9.3 percent.
- Corporations: 8.84 percent.
- Banks and financial corporations: 10.84 percent.
- S corporations: 1.5 percent
- Financial S corporations: 3.5 percent

We are creating form 593E, *Real Estate Withholding – Computation of Estimated Gain or Loss* to include an online calculator (see "Forms" section below) on our Website to help sellers calculate the amount of gain, and the alternate withholding amount.

Sellers electing an alternate withholding amount will be required to certify the amount in writing, under penalty of perjury.

### Withholding agent responsibilities

The responsibilities of the withholding agent and real estate escrow officer have not changed. The withholding agent is still expected to provide certain forms to the seller and certain forms to the buyer, and then withhold accordingly. The real estate escrow officer is still required to provide written notification to the buyer. The escrow officer's notification to the buyer has been amended, however, to include language regarding the alternate withholding amount.

We have also created the FTB forms used to calculate, and to elect the alternate withholding amount. These forms state that title and escrow officers are not authorized to provide legal or accounting advice for the purposes of determining the withholding amounts, and that sellers should consult tax professionals for advice.

### Forms

With new laws come new forms, and changes to existing forms. The forms for 2007 have not been finalized; however, we expect to have the forms available in mid-to-late December. All current forms are online and fillable.

The following changes are planned:

- **Form 593-B, *Real Estate Withholding Tax Statement***. The escrow officer or withholding agent will continue to submit this form to FTB along with Form 593, *Real Estate Withholding Remittance Statement*. In addition, Form 593-B will be used to notify FTB of the seller's election, and the certified alternate withholding amount. If electing the certified withholding amount, the seller's signature is required on Form 593-B.

- **Form 593-C, *Real Estate Withholding Certificate***. The seller will continue to complete, sign, and submit this form to the escrow officer, to claim a withholding exemption.

- **Form 593-E, *Real Estate Withholding – Computation of Estimated Gain or Loss*.** This form replaces Form 593-L (described below), and will be used by the seller to calculate the loss or gain on the sale, and the reduced withholding amount. If claiming an exemption based on the loss calculation or electing the alternate withholding amount based on the gain, the seller is to complete, sign, and maintain this form for five years.

- ***Electronic Calculator Form*** (**NEW**) – In addition to the Form 593-E, we will have an electronic calculator on our Website that mimics the Form 593-E. The seller can use this form to calculate the loss and gain on the property, and the alternate withholding amount. When the form prints, it will print as a Form 593-E.

- **Form 593-L, *Real Estate Withholding – Computation of Estimated Gain or Loss.*** This form is discontinued and replaced with Form 593-E.

We do not anticipate significant changes to Form 593, *Real Estate Withholding Remittance Statement* or Form 593-I, *Real Estate Withholding Installment Sale Agreement*, except to include language relating to the alternate withholding amount.

### Forms FAQs

**1. How does the seller elect to withhold on the gain?**

- The seller calculates the amount of gain and the alternate withholding amount on Form 593-E, *Real Estate Withholding – Computation of Estimated Gain or Loss.* If electing the alternate withholding amount, the seller completes, signs, and maintains the Form 593-E for five years.
- The seller must certify Form 593-B, *Real Estate Withholding Tax Statement,* which the withholding agent submits to FTB, along with Form 593, *Real Estate Withholding Remittance Statement,* and the withholding amount.

**2. Who is responsible for completing and maintaining Form 593-E, *Real Estate Withholding – Computation of Estimated Gain or Loss*?**

The seller is responsible for completing Form 593-E, which assists in calculating the loss, or zero gain, and the alternate withholding amount. If claiming a loss, or zero gain, or electing an alternate withholding amount, the seller must complete and certify the form. The seller is to maintain the form for five years and furnish the form to FTB upon request. After completing this form, the seller must certify Form 593-B to elect the alternate withholding amount, and give the completed Form 593-B to the withholding agent.

3. **Is the seller required to complete, sign, and provide the withholding agent with the completed Form 593-C, *Real Estate Withholding Certificate*?**

   No. This form is to be completed only if the seller claims a full or partial withholding exemption. Under those circumstances, the seller must give a completed and certified Form 593-C to the withholding agent. Otherwise, the withholding amount will be either three and one-third percent of the total sale price, or the alternate withholding amount certified by seller on Form 593-B.

4. **Is the withholding agent responsible for verifying the alternate withholding amount stated on Form 593-B?**

   No. As long as the form is complete, and certified under penalty of perjury, no other verification is required.

5. **Is the seller required to provide the Form 593-E to the withholding agent?**

   No. The seller completes, certifies, and maintains Form 593-E if claiming a withholding exemption due to a loss or zero gain on the sale, or if the seller elects the alternate withholding amount. The seller is to maintain the form for five years, and furnish the form to FTB upon request. If electing the alternate withholding amount, the seller must provide the withholding agent with a signed Form 593-B.

6. **In an installment sale, is the seller required to sign Form 593-B for each installment payment submitted to FTB?**

   No. If the buyer elects to withhold on each installment payment, the buyer will be required to execute Form 593-I, R*eal Estate Withholding Installment Sale Agreement.* Form 593-I must be submitted to FTB along with a copy of the signed promissory note (showing the installment payment requirements), and a copy of the seller's original certification of Form 593-B (which is submitted on the first payment in escrow or by the withholding agent). While a new Form 593-B must be completed and submitted with each installment payment, the buyer will not be required to obtain the seller's signature each time the buyer submits additional withholding payments.

We will update our Website, www.ftb.ca.gov (search for *real estate*), as new information, forms, and publications become available.

**Make sure you're using FTB-approved substitute or scannable forms**

If you plan to use tax preparation software next year, be sure the California income tax forms generated from your software meet the requirements of our Substitute Forms Program. Filing tax returns on unapproved forms can lead to processing delays. And, in those cases where we cannot process the tax returns, we will have to contact your clients directly to resolve the processing problems.

All companies that manufacture and sell tax preparation software that generate California income tax forms must file an agreement with us stating their intent to comply with our requirements for the 2006 tax year. By signing form FTB 1096, *Agreement to Comply with FTB Publication 1098 Annual Requirements* (search for "2006 FTB 1096" on our Website, www.ftb.ca.gov), the company agrees to follow the rules for developing substitute and scannable forms.

Filing form FTB 1096 is the first step in the approval process. The second step is making sure that tax software companies actually comply with our annual requirements, and obtain our approval for use in the coming year. Tax software companies that produce substitute and scannable forms are required each year to submit their forms to us for approval before they are offered to their customers.

If you are unsure whether the forms you plan to use this upcoming filing season are FTB-approved, ask your software provider to show you the FTB-issued approval letter for **each** form you plan to use, before you use it. Don't accept a general statement from your provider that all company forms have been approved. Instead, give your provider a list of the forms you plan to use, and ask your provider to give you a copy of the FTB approval letter for each form.

**Note**: Companies that either sell or provide photocopies of official FTB forms do not need to submit them for approval.

At press time, the following software companies filed form FTB 1096 with us:

| Company name | Telephone number |
|---|---|
| 5227 Tax System Inc. | (626) 578-1978 |
| 2nd Story Software, Inc. | (319) 373-3600 |
| Accountant Stationers and Printers | (213) 749-9241 |
| American Financial and Tax | (714) 669-1172 ext. 105 |
| ATX II, LLC | (800) 944-8883 |
| Block Financial Corporation | (800) 869-9220 |
| BNA Software | (301) 367-4290 |
| Brass Tax Presentations | (858) 487-2331 |
| C & S Technologies | (408) 935-8468 ext. 104 |
| CCH Tax and Accounting | (800) 739-9998 |
| CFS Tax Software, Inc. | (800) 343-1157 |
| Clientwhys, Inc. | (818) 338-8700 ext. 240 |
| CorpTax, LLC | (847) 236-8000 |

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|---|---|
| Creative Solutions | (800) 968-0600 |
| Data Technology Group | (315) 493-1120 |
| Deloitte & Touche USA LLP | (615) 882-6068 |
| Drake Software | (828) 524-8020 |
| Exactax, Inc. | (714) 284-4802 ext. 219 |
| Eztaxreturn.com | (516) 626-7666 ext. 474 |
| Fileyourtaxes.com | (805) 644-9398 |
| Gear Up Tax Seminars | (916) 645-1040 |
| H & R Block, Inc. | (816) 854-3416 |
| HowardSoft | (858) 454-0121 |
| Intuit, Inc. | (858) 525-7108 |
| Jackson Hewitt Tax Service | (941) 378-7127 |
| Lamson Tech | (215) 627-5874 |
| Legal Aid Society of Orange County | (714) 571-5200 |
| Nelco Solutions | (800) 256-4669 |
| On-line Taxes, Inc. | (816) 232-0095 |
| Online Tax Pros, Inc. | (479) 968-4796 |
| Orrtax Software Solutions, Inc. | (425) 649-8291 ext. 8141 |
| Petz Enterprises | (209) 835-2720 ext. 2105 |
| Phoenix American Financial Services, Inc. | (415) 485-4500 |
| Pricewaterhouse Coopers LLP | (813) 329-9548 |
| Lawrence Livermore National Laboratory | (925) 422-1100 |
| Rhodes Computer Services | (706) 868-0985 |
| RIA | (800) 327-8829 |
| SDDS Computer Accounting | (909) 987-2408 |
| Spidell Publishing, Inc. | (714) 776-7850 |
| Software Sourcery Systems, Inc. | (619) 469-4844 |
| Southern California Permanente Medical Group | (626) 405-3024 |
| STF Services Corporation | (800) 541-7197 |
| Tax Biz | (408) 243-1472 |
| Tax Hawk | (435) 669-1122 |
| Taxsation Inc. | (888) 829-1120 ext. 150 |
| Tax$imple, Inc. | (973) 989-8955 |
| Taxware Systems, Inc. | (800) 877-1065 |
| TaxWorks by Laser Systems | (801) 529-9150 |
| Trust Tax Services of America | (508) 753-9311 ext. 156 |
| Universal Tax Systems, Inc. | (706) 290-7287 |
| Vertex, Inc | (941) 342-3674 |
| WeFile, Inc. | (800) 790-3863 |
| Wilson LLP | (404) 841-6250 |
| Wolters Kluwer | (847) 267-7336 |
| World Tax Partners | (972) 236-6716 |
| Zond Panaero Windsystem Partners I | (713) 853-5172 |
| Zond Panaero Windsystem Partners II | (713) 853-5172 |
| Zond Windsystem Energy Associates III | (713) 853-5172 |
| Zond Windsystem Energy Associates IV | (713) 853-5172 |
| Zond Windsystem Energy Associates V | (713) 853-5172 |

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| Zond Windsystem Energy Associates VII | (713) 853-5172 |
| Zond Windsystem Energy Associates XII | (713) 853-5172 |
| Zond Windsystem Partners, LTD. Series 85-A | (713) 853-5172 |
| Zond Windsystem Partners, LTD. Series 85-B | (713) 853-5172 |
| Zond Windsystem Partners, LTD. Series 85-C | (713) 853-5172 |

### Disclosure of list of corporations under audit

On September 20, 2006, an FTB employee in charge of monitoring the timely completion of audits inadvertently disclosed information about 256 corporations. The disclosed information includes the corporation name, California corporate number, first and last tax year, name of the auditor, and assigned status. No tax return financial information was disclosed.

On September 22, 2006, we sent letters to all affected corporations, notifying them of the incident.

In addition to notifying the affected corporations, we are taking these immediate, preventive steps:

- Removing the mail ID accidentally used by the employee, and most external email IDs, from the departmental email address book. We are investigating the most effective method for preventing the inappropriate use of the remaining external email IDs needed to conduct normal FTB business.
- Providing expanded education to our employees, on the appropriate use of email.

We are aggressively investigating long-term solutions to prevent the intentional, or unintentional release of confidential information via email in the future.

### Ongoing efforts

FTB's information system has layers of security to monitor and protect taxpayer data. All FTB employees receive mandatory annual training in how to prevent disclosure, and maintain taxpayer confidentiality. As part of this training, employees are informed that they can lose their jobs if they intentionally view taxpayer data they are not authorized to see.

## Taxing municipal bond interest in California

In a recent decision by the Kentucky Court of Appeals, the court ruled that it is unconstitutional to tax interest from out-of-state municipal (muni) bonds, while in-state muni bond interest is tax exempt (*Davis v. Department of Revenue (*January 6, 2006) Case No. 2004-CA-001940-MR). This case came before Kentucky's Supreme Court in August 2006, and the court denied review of the decision. The Kentucky Department of Revenue has indicated that it will ask the U.S. Supreme Court to review the Kentucky decision.

How do the Kentucky court decisions affect California taxpayers who invest in out-of-state muni bonds? There is no effect. Judicial decisions regarding the validity of Kentucky law do not affect California law. California taxpayers must continue to follow existing California law, and pay income tax on non-California muni bond interest. **Note**: All interest of government obligations is subject to the corporate franchise tax.

For non-California muni bonds to be considered tax-exempt in California, at least one of the following must occur:

- A change to existing California law.
- A final decision from a California appellate court finding that it is unconstitutional to tax interest from out-of-state muni bonds, if interest from in-state muni bonds is tax-exempt.

Until one of these changes occurs, FTB will deny claims filed for a refund or credit if they are based on the Kentucky court decisions. Your clients can respond to our denial of their claims through the appeal process. If you file amended returns for your clients for the Muni Bond issue, write "Muni Bond" at the top of the returns, and mail them to the appropriate addresses below.

**For personal income tax refunds:**
Franchise Tax Board
P O Box 942840
Sacramento CA 94240-0000

**For refunds of corporate income tax:**
Franchise Tax Board
P O Box 942857
Sacramento CA 94257-0501

## Criminal Corner

We are committed to closing California's $6.5 billion tax gap, defined as the difference between tax that is owed and tax that is paid. Our special agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees.

Tax fraud is not a victimless crime. You can report suspected tax fraud by calling FTB at (800) 540-3453.

Cases prosecuted in the last month are described below.

**Huntington Beach man sentenced in embezzlement, tax case**
A Huntington Beach man was sentenced on October 20, 2006, on felony charges of tax evasion related to the theft of more than $2.2 million from "The Gas Company."

Joseph Pierro, 68, was sentenced to two years in a California Restitution Center and ordered to pay FTB $99,108 in restitution. (Restitution Centers are established and operated by the Director of Corrections, and authorized by Chapter 9.2 of the California Penal Code: "The purpose of restitution centers is to provide a means for those sentenced to prison to be able to pay their victims financial restitution as ordered by the sentencing court, or as agreed upon by the defendant and his or her victims.")

Pierro was one of seven individuals arrested in September 2004 for embezzling more than $2.2 million from The Gas Company (see "Criminal Corner," *Tax News,* November/December 2005). According to court documents, this group was involved in a scheme where more than 300 fraudulent invoices were issued between December 7, 1995, and January 3, 2002. The payments on the invoices were to an individual, a corporation, and five sham corporations that allegedly split the proceeds with the scheme's ringleader or paid his personal expenses. Pierro operated IDI Technologies, which was involved with more than $400,000 in fraudulent invoices.

**Trina Jesson sentenced for her role in tax evasion scheme**
On October 20, 2006, the wife of a convicted tax evader was ordered to pay more than $437,000 in restitution, and placed on three years formal probation for her role in the filing of false state income tax returns.

Trina Jesson, 43, was involved with her husband, George H. (Nick) Jesson, in a promotion questioning the legality of withholding personal income taxes (see "Criminal Corner," *Tax News*, September 2006). Mr. Jesson is currently in federal prison in Lompoc after pleading guilty to federal and state tax charges. The Jessons owned and operated three corporations in Huntington Beach: Capacitor Specialist International, Inc., No Time Delay Electronics, Inc., and C&D Electronics, Inc. According to court records, the Jessons failed to report more than $2.9 million from these corporations on their state income tax returns for 1997-1999 by zeroing out the amount fields on their tax returns.

The Jessons believed that withholding personal income taxes violated the Constitution, and that their employees could request to have no tax withheld from their paychecks. Mr. Jesson and others placed an ad in a national newspaper stating their refusal to withhold taxes from employee paychecks. The courts routinely strike down frivolous anti-tax arguments like this.

Trina Jesson was ordered to pay restitution to the FTB of $437,611 including tax, penalties, and interest. A hearing on the cost of the investigation is scheduled for December 15, 2006.

## The buzz on big business

### California Supreme Court issues decisions on Microsoft and General Motors

Apportioning corporations that have substantial treasury function gross receipts could find that their California sales apportionment factor is affected. The California Supreme Court issued two decisions on August 17, 2006, affecting apportioning corporations. The decisions relate to taxpayers' treasury function gross receipts, the apportionment sales factor of Revenue and Taxation Code (R&TC) Section 25136, and distortion analysis provided by R&TC Section 25137. On September 28, 2006, we issued FTB Notice 2006-3, explaining FTB's position on the application of the accuracy-related penalty under R&TC Section 19164 in gross receipts on intangible sales cases.

Although the California Supreme Court decisions are not final, we are evaluating the decisions issued on, and exploring guidance from the decisions (Microsoft Corp. v. FTB [California Supreme Court, Docket No. S133343], and General Motors Corp. v. Franchise Tax Board [California Supreme Court, Docket No. 127086]).

The California Supreme Court has indicated that the amount realized on redeeming marketable securities as part of a business's treasury function, qualifies as "gross receipts" for purposes of the sales factor, and therefore should be included in the sales factor. R&TC Section 25137 provides an exception that would take the gross receipts back out of the sales factor, if their inclusion would give a distorted picture of the taxpayer's activity in California.

We are analyzing the two court decisions, and exploring how to incorporate the guidance from these decisions in the audits of other taxpayers. Although the cases address the amount of gross receipts to be included in the sales factor **denominator**, taxpayers with treasury functions in California could potentially have sales factor **numerator** effects from the court's decisions.

As the California Supreme Court cited, with approval, the State Board of Equalization decision in the Appeal of Pacific Telephone & Telegraph (California State Board of Equalization, May 4, 1978, 78-DBE-028), we anticipate that we will need to apply the "Pac Tel" analysis in more audit cases. In addition to the long-standing "Pac Tel" analysis, FTB will be comparing the profit margins of the ancillary treasury functions with the profit margins of the core operations of the taxpayers, to determine if distortion exists.